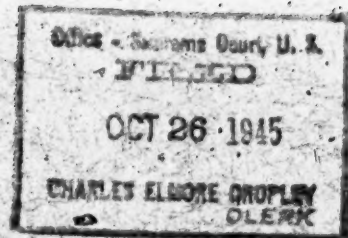


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No. 56

In the Supreme Court of the United States

OCTOBER TERM, 1945

KIRBY PETROLEUM COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

**ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT
COURT OF APPEALS FOR THE FIFTH CIRCUIT**

BRIEF FOR THE RESPONDENT

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (R. 10-17) is reported at 2 T. C. 1258. The opinion of the Circuit Court of Appeals (R. 38-43) and the dissenting opinion in that court (R. 44-50) are reported at 148 F. 2d 80.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 5, 1945 (R. 50). The petition for a writ of certiorari was filed on April 9, 1945, and was granted on May 21, 1945 (R. 51). The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer was the owner of the fee simple title to two tracts of land. As to one tract, however, there was an outstanding one-eighth mineral interest. The properties were leased for oil and gas exploration and production, the taxpayer retaining a royalty of one-sixth of all oil produced and saved and varying royalties on other minerals. By a separate, contemporaneous agreement, which formed part of the consideration for the lease, the taxpayer became entitled to 20 percent of the net profits earned by the lessees as a result of their operations.

The question is whether the Circuit Court of Appeals erred in holding that the taxpayer was not entitled, under Sections 23 (m) and 114 (b) (3) of the Internal Revenue Code, to a deduction for depletion on its share of the lessees' net profits.

STATUTE AND REGULATIONS INVOLVED

The relevant provisions of the statute and regulations involved are set forth in the Appendix, *infra*, pp. 43-47.

STATEMENT

The facts in this case were stipulated by the parties (R. 22-36), and were found by the Tax Court as stipulated (R. 11).

Taxpayer owned the fee simple title to two tracts of land except that, as to one tract, a one-eighth mineral interest was outstanding (R. 12,

23). On September 29, 1927, taxpayer entered into a lease with the Humble Oil & Refining Company and the Marland Oil Company of Texas, as lessees (R. 12, 22). Under the lease, which was for the term of five years and as long thereafter as oil or gas should be produced, the lessees acquired the right of "investigating, exploring, prospecting, drilling and mining for and producing oil, gas and all other minerals" (R. 24).

The lease contained provisions for the payment of delay rentals in the event that the lessees had not commenced drilling operations in accordance with the provisions of the lease (R. 25-26). There were also provisions for the drilling of further wells in the event that dry holes should be drilled prior to the discovery of oil or gas. Also, in the event that oil was discovered on adjacent property, the lessees were obligated to drill offset wells (R. 26-27).

The lease provided that all obligations of the lessees were to be understood as covenants and not as conditions or limitations, and that the breach thereof "shall not work a forfeiture or termination of this lease nor cause a termination or reversion of the estate created hereby * * *" (R. 27).

The taxpayer received a cash bonus upon the execution of the lease (R. 24) and reserved the right to a royalty of one-sixth of the oil produced and saved, one-sixth of the amount realized from the sale of gas at the wells, the market price of

one-sixth of the gas sold or used off the premises, and, in the event that the lessees manufactured gasoline or other products from the gas, one-sixth of 25 percent of the market value thereof (R. 12, 25). Contemporaneous with the making of the lease, the parties executed an agreement (R. 29-34) as part of the consideration for the lease (R. 12, 24). Under the terms of the agreement, taxpayer was entitled to 20 percent of the "net money profits" realized by the lessees from their operations under the lease (R. 12, 30). The agreement provided a method for the calculation of the net profits and specified the occasions on which taxpayer's share was to be paid (R. 12, 31-33, 34).

During the year 1940, taxpayer received \$26,223.70 as its share of the net profits. In its income tax return for 1940, taxpayer deducted depletion to the extent of $27\frac{1}{2}$ percent of this amount (R. 13, 23). The Commissioner's notice of deficiency disallowed the depletion deduction on this amount (R. 6-9), and the taxpayer sought a redetermination of the deficiency before the Tax Court (R. 2-5). The Tax Court ruled that the taxpayer was entitled to the depletion deduction (R. 11-16), and entered its decision determining a deficiency in income tax arising out of matters not here in dispute (R. 16-17). The Circuit Court of Appeals, Judge Hutcheson dissenting, reversed the Tax Court (R. 50).

SUMMARY OF ARGUMENT

I

The provisions of the statute, the treasury regulations, and the holdings of this Court with respect to the deduction for depletion, point in only one direction, namely, that the single allowance is to be apportioned among the parties in the same proportion as they are entitled to share in the production of the oil and gas, or the gross proceeds derived therefrom. The lessees in this case acquired the right to all the oil in place and its production except to the extent that a bonus was paid and there was an obligation to pay oil royalties. Accordingly, the lessees were entitled to the full amount of the depletion deduction except for the portion representing the share of the oil produced to which others were entitled. The lessor, the taxpayer in the case, was entitled to the deduction for depletion only to the extent that it retained a right to share in the oil produced, evidenced by the cash bonus and the oil royalties received. There being no assurance that production will give rise to net profits, taxpayer's right to receive a share of the lessees' profits is not an interest in the production of oil or in the gross proceeds; taxpayer was not entitled to any depletion on the payments received, and the lessees' right to the deduction could not be defeated to that extent.

II

The Circuit Court of Appeals did not disregard any findings of fact made by the Tax Court or any inferences that were drawn therefrom. The decision of the Tax Court that under the statute, the regulations, and the decisions of this Court, the taxpayer had a right to depletion on the share of the lessees' net profits which it received, was not in accordance with law and was properly reversed by the Circuit Court of Appeals.

ARGUMENT

I

A LESSOR OF OIL AND GAS PROPERTY WHO IS PAID A SHARE OF THE NET PROFITS EARNED BY THE LESSEE MAY NOT DEDUCT PERCENTAGE DEPLETION ON THE AMOUNTS SO RECEIVED

The taxpayer in this case is the lessor of certain oil producing property. As consideration for the lease, the taxpayer received a cash bonus payment, and became entitled to a one-sixth oil royalty,¹ and, in addition, to one-fifth of the net profits earned by the lessees from their operation of the leased property. The question involved concerns the amount of the percentage depletion deduction which may be taken by the taxpayer

¹ The term "royalty," as used herein, means a fractional portion of the oil and gas produced, or of the gross proceeds from the sale thereof, which is reserved by the lessor. See *Anderson v. Helvering*, 310 U. S. 404, 409.

under Section 23 (m) and Section 114 (b) (3) of the Internal Revenue Code (Appendix, *infra*, pp. 43-44). There is no dispute concerning the taxpayer's right to depletion on the cash bonus payment and the oil royalties received. The only issue in this case is whether the taxpayer is also entitled to depletion with respect to the share of the lessees' net profits it received, thereby reducing the amount of the single depletion allowance available to the lessees.

It is the Commissioner's position that under Section 114 (b) (3), construed in conjunction with Section 23 (m) which provides that the depletion allowance shall be equitably apportioned between the lessor and the lessee under rules and regulations promulgated by the Commissioner, and under the decisions of this Court and the applicable treasury regulations, the single depletion allowance can only be apportioned between the lessor and lessee in the same proportion as each is entitled to share in the production of the oil; the single allowance for depletion is subject to apportionment among only those persons who have an interest in the oil and gas which is directly related to the amount of production taking place and which, consequently, suffers physical depletion concurrently and proportionately as production occurs. The single deduction for depletion being shared by such persons in relation to their respective interests in production, all others are necessarily excluded

from participation. The Commissioner further maintains that since the lessor's right to participate in the lessee's net profits is not an interest entitling the lessor to share in the oil produced, no part of the depletion allowance can be taken with respect to the net profits received.

The same basic considerations which establish to whom the gross income from the property is taxable likewise determine who is entitled to the deduction for depletion. "That issue is, who has a capital investment in the oil and gas in place and what is the extent of his interest." *Anderson v. Helvering*, 310 U. S. 404, 407. The possession of a capital investment in the oil and gas in place is the essential requirement for establishing a depletable interest since the "term 'gross income from the property' " on which the statute² permits percentage depletion to be taken "means gross income from the oil and gas." *Helvering v. Mountain Producers Corp.*, 303 U. S. 376, 382. This follows from the very nature of the depletion allowance which is granted, as a matter of legislative grace, to compensate for the consumption of capital assets during the process of extracting the mineral deposits. *Helvering v. Bankline Oil Co.*, 303 U. S. 362, 366-367. Therefore, if a taxpayer has "no capital investment in the mineral deposit which suf-

² Section 114 (b) (3) of the Internal Revenue Code.

ferred depletion," he "is not entitled to the statutory allowance." *Helvering v. Bankline Oil Co.*, *supra* at p. 368.

If a taxpayer has a capital investment in only a portion of the mineral deposits, he is not entitled to depletion beyond the extent of his interest; he may claim only the allowance with respect to "the gross income from production" which he has "the right to retain." *Helvering v. Twin Bell Syndicate*, 293 U. S. 312, 321. See also *Bankers Coal Co. v. Burnet*, 287 U. S. 308.

In ascertaining the nature and extent of a taxpayer's capital investment in the oil and gas deposits, legal ownership under state law is not a determinative factor. *Burnet v. Harmel*, 287 U. S. 103; *Palmer v. Bender*, 287 U. S. 551. Nor is a taxpayer's interest to be determined from the form of the particular instrument involved or from the formalities of the kind of conveyance made; instead, it is the "practical consequences of the provision for payments" which are decisive of this matter. *Anderson v. Helvering*, 310 U. S. 404, 411. Accordingly, it is quite immaterial that the taxpayer here possessed the fee ownership of the surface land or might reacquire, because of its reversionary rights, the economic interest in all the underlying minerals upon a forfeiture of the lease. Cf. *Pet. Br.* 9, 24. Indeed, the owner of land has nothing more than the right to take possession of the oil and gas, and when that right is transferred, as it was

here, it makes no difference whether the transfer is by way of a lease rather than a sale. See ⁴Mertens, *Law of Federal Income Taxation* (1942), sec. 24.08, p. 213.

This Court has always held that the provisions for payment (whether acquired or retained) which evidence the existence of a depletable interest are those which arise from a direct interest in the oil which is being produced. Thus, the retention by the lessor of a share of gross production by way of an oil royalty gives the lessor a proportionate depletable interest in the mineral deposits. *Bankers Coal Co. v. Burnet*, 287 U. S. 308. The royalties received constitute ordinary income of the lessor from the property and are not considered part of the lessee's income, even though the lessee may have collected the full amount in the first instance before paying the lessor's share to him. *Helvering v. Twin Bell Syndicate*, 293 U. S. 312; *Palmer v. Bender*, 287 U. S. 551. Important here is the fact that the lessor's royalty interest gives rise to taxable income and a depletable interest because it constitutes a share of gross production. As this Court said in *Palmer v. Bender*, *supra* (pp. 557, 558):

It is enough if, by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production.

* * * * *

Thus, throughout their changing relationships with respect to the properties, the oil in the ground was a reservoir of capital investment of the several parties, all of whom, the original lessors, the two partnerships and their transferees, *were entitled to share in the oil produced*. Production and sale of the oil would result in its depletion and also in a return of capital investment to the parties *according to their respective interests*. [Italics supplied.]

Where the lessor retains the right to share in gross production up to, but not beyond, a stated consideration, by means of an oil payment, such a reservation gives the lessor a proportionate depletable interest in the oil deposits; it constitutes ordinary income to the lessor, and it is not part of the income of the lessee. *Thomas v. Perkins*, 301 U. S. 655; *Palmer v. Bender*, 287 U. S. 551; *Anderson v. Helvering*, 310 U. S. 404, 410-413. In such a situation the provision for an oil payment is "regarded as a reservation from the granting clause of an amount of oil sufficient to make the agreed payments"; accordingly, it is "given the same tax consequences as a provision for oil royalties." *Anderson v. Helvering*, *supra* at p. 411. This, however, is true only where "the reserved payments are to be derived solely from the production of oil and gas" (*Anderson v. Helvering*, *supra* at p. 413), and it will be noted that in the *Anderson* case the Court recognized that in the interests "of a workable rule" the doctrine of

Thomas v. Perkins, supra, should not be extended to other situations.

Where the lessor receives a cash bonus and also reserves a continuing interest in gross production, the bonus is considered as the payment of advance royalties and is given the same effect so far as depletion and taxable income are concerned. *Herring v. Commissioner*, 293 U. S. 322; *Palmer v. Bender*, 287 U. S. 551; *Bankers Coal Co. v. Burnet*, 287 U. S. 308; *Murphy Oil Co. v. Burnet*, 287 U. S. 299; *Burnet v. Harmel*, 287 U. S. 103; *Commissioner v. Clarion Oil Co.*, 148 F. 2d 671 (App. D. C.), certiorari denied, June 18, 1945. The fact that a depletable interest cannot exist unless it has a direct relationship to production is evident from the fact that the depletion taken with respect to a bonus must be restored to income if no production subsequently takes place. *Douglas v. Commissioner*, 322 U. S. 275; Section 19.23 (m)-10 (c), Treasury Regulations 103.

The economic interest of each of the parties entitled to participation is his share of the gross production of the oil or the gross income from its sale. This was specifically recognized in *Helvering v. Twin Bell Syndicate*, 293 U. S. 312, where the Court said (p. 321):

* * * we are unable to say that the Commissioner erred in holding that for the purpose of computation "gross income from the property" means gross income from production less the amounts which the tax-

payer was obligated to pay as royalties. The apportionment gives respondent 27½ per cent. of the gross income from production which it had the right to retain and the assignor and lessor respectively 27½ per cent. of the royalties they receive. Such an apportionment has regard to the economic interest of each of the parties entitled to participate in the depletion allowance. [Italics supplied.]

It follows that, when the depletion allowance is apportioned in accordance with the respective interests of the parties in the gross production of the oil (or the gross income therefrom), no other interest can be entitled to a deduction for depletion. That is necessarily so since no other interest is derived from the gross income obtained from the production and sale of the oil.

Thus, where the lessor of oil and gas properties receives an advance on production in the form of a cash bonus and a fractional portion of production, in the form of an oil royalty, and also a fractional portion of production until a certain sum has been received, in the form of oil payments, those items constitute the "gross income from the property" which is taxable to the lessor and with respect to which he is entitled to a deduction for depletion. All the remainder of the gross production is attributable to the lessee; the proceeds from that amount of the oil constitute his gross income, and are "the gross income from the prop-

erty" with respect to which he is entitled to depletion.

Where the lessor, in addition to a bonus, oil royalties, and oil payments, is entitled to receive a portion of the net profits earned by the lessee from his operations, the net profits received cannot represent the return on a capital investment which is depletable. As analyzed above, when the lessor receives depletion on the share of gross production which he has reserved, the lessee must be entitled to depletion on all the remaining gross production since the gross proceeds from that production arise from his share of the oil and are attributable to him and to him alone.

The principle that an interest in net profits cannot constitute a depletable interest follows not only from the above-cited cases, but has been specifically applied by this Court. Thus, in *Helvering v. Elbe Oil Land Co.*, 303 U. S. 372, the taxpayer, the owner of certain oil property, had transferred it for a stated consideration, part of it payable at the time of the execution of the agreement, and additional amounts payable in succeeding years if the transferee should elect not to abandon the transaction. The taxpayer, in addition, was entitled to receive one-third of the net profits which the transferee might earn after having been fully reimbursed for its expenditures in the acquisition, development, and operation of the properties. It was held that the taxpayer was not to be permitted a deduction for depletion on

the cash payments received, it being decided that no interest was retained by the taxpayer in the oil and gas in place and that, consequently, the cash payments did not constitute a bonus. In holding that the provision for paying a portion of the operator's net profits did not make the transaction one where the taxpayer would receive income from the production and sale of oil, the Court stated (pp. 375-376):

In this view, neither the cash payments nor the agreement for a share of subsequent profits constituted an advance royalty, or a "bonus" in the nature of an advance royalty, within the decisions recognizing a right to the depletion allowance with respect to payments of that sort. * * * The words "gross income from the property," as used in the statute governing the allowance for depletion, mean gross income received from the operation of the oil and gas wells by one who has a capital investment therein,—not income from the sale of the oil and gas properties themselves.

The *Elbe* case cannot be distinguished on the ground that there the transaction was in the form of a sale of the property, while here the parties entered into a leasing agreement. Cf. Pet. Br. 20-21. As previously pointed out (*supra*, pp. 9-10), it is the particular provisions for payment, not the form or the manner of transfer which is determinative. *Anderson v. Helvering*, 310 U. S. 404, 411. Accordingly, the *Elbe* case must stand for

the proposition that the reservation of the right to share in the operator's profits is not the retention of a depletable interest in the oil and gas deposits. If an interest in net profits were a royalty interest, or analogous to one,³ the cash payments in the *Elbe* case would have been regarded as a true bonus or advance royalties, and depletable. See *supra*, p. 12, and *infra*, pp. 23-24. But, it was for the precise reason that the provision for sharing in the operator's profits did not give the taxpayer any interest in the production of the oil, and therefore, did not represent a depletable interest in the underlying oil, that the cash payments received in the *Elbe* case could not constitute advance royalties. Obviously, the money received could not be regarded as advance payment for future production when the taxpayer would never become entitled to any future production.

Similarly, in *Helvering v. O'Donnell*, 303 U. S. 370, the taxpayer was the owner of one-third of the stock of a corporation which possessed certain oil and gas properties. He sold the stock to another corporation which agreed to acquire the oil property and to pay to the taxpayer one-third of its net profits from development and operations. It was held that the taxpayer was not entitled to deduct an allowance for depletion on the portion of the net profits which he received since he had no capital investment in the oil and gas in place.

³ That such an interest is not a royalty interest is evident from *Anderson v. Helvering*, 310 U. S. 404, 409.

No material distinction can be made because, prior to the transaction, the taxpayer in the *O'Donnell* case had no economic interest in the oil and gas in place, he being only a stockholder in the corporation which owned the property. Cf. Pet. Br. 19-20. Plainly, if the taxpayer there had acquired a true royalty interest, instead of a share of operating profits, his right to share in gross production would have given him a proportionate depletable interest. The decision actually demonstrates that since the transferee was entitled to all the gross production, it possessed the entire depletable capital investment; since the taxpayer's right to participate in net profits did not entitle it to share in production as it took place, he could not have an interest in the oil deposits which would become exhausted as extraction occurred. In this respect, the Court stated (pp. 371-372):

When the Midway Company acquired these properties from the San Gabriel Company and operated them, *the Midway Company became the owner of the oil and gas produced. It was the owner of the gross proceeds or income upon which the statutory allowance for depletion was to be computed. Helvering v. Twin Bell Syndicate, supra.* The agreement to pay respondent one-third of the net profits derived from the development and operation of the properties was a personal covenant and did not purport to grant respondent an interest in the properties themselves. If there were no net

profits, nothing would be payable to him. No trust was declared by which respondent could claim an equitable interest in the *res*. As consideration for the sale of his stock in the San Gabriel Company respondent bargained for and obtained an economic advantage from the Midway Company's operations but that advantage or profit did not constitute a depletable interest in the oil and gas in place. [Italics supplied.]

The *O'Donnell* and *Elbe* cases, *supra*, were summarized in *Anderson v. Helvering, supra*, as follows (p. 409):

A share in the net profits derived from development and operation, on the contrary, does not entitle the holder of such interest to a depletion allowance even though continued production is essential to the realization of such profits.

The requisite interest in production which gives rise to a depletable interest, as distinguished from a mere economic advantage derived from production which does not evidence a capital investment in the underlying minerals, is also illustrated by *Helvering v. Bankline Oil Co.*, 303 U. S. 362. It was there held that a processor of casinghead gas who was entitled to receive the gas as it was produced, but who could not compel its production; did not have any interest in the wet gas in place and was not entitled to claim a deduction for depletion. The *Bankline* case thus follows the constant pattern of the decisions that a depletable interest in the underlying minerals can

only be attributed to the persons who have such a direct economic interest in gross production that the gross income derived therefrom may be said to result from the severance and sale of their oil.

Treasury Regulations 103, Appendix, *infra*, pp. 44-47, specifically exclude an interest in net profits from being a depletable interest, Section 19.23 (m)-1 providing:

But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or *to share in the net income derived from the interest of such owner does not convey a depletable economic interest.* [Italics supplied.]

The basis for the decision of the Circuit Court of Appeals for the Ninth Circuit in *Commissioner v. Crawford*, 148 F. 2d 776, petition for a writ of certiorari granted, No. 197, this Term (to be argued immediately after this case), holding that the interest in net profits there involved was a depletable interest, is not clear. It seems, however, that the Court failed to distinguish between a fee interest in the property and an economic interest in the oil and gas in place. Cf. *Anderson v. Helvering*, 310 U. S. 404.

The Tax Court, it would appear, regards an interest in the operator's net profits as being depletable only when it is accompanied by a royalty interest in gross production. Thus, in contrast to its decision in the present case and its decision in *Crawford v. Commissioner*, decided March 24, 1944 (1944 P-H T. C. Memorandum Decisions, par. 44,098), affirmed 148 F. 2d 776, petition for a writ of certiorari granted, No. 197, this Term, the Tax Court held, in *Estate of Japhet v. Commissioner*, 3 T. C. 86,⁴ that the assignor of an oil and gas lease who received a lump sum payment and who was entitled to a share of the operator's net profits, did not retain a depletable interest. The Tax Court distinguished its decision in the present case, stating (p. 93):

Our recent decision in *Kirby Petroleum Co.*, 2 T. C. 1258, is distinguishable. In that case the taxpayer in its assignment of

⁴ Compare, however, *Felix Oil Co. v. Commissioner*, decided December 18, 1942 (1942 P-H B. T. A. Memorandum Decisions, par. 42,662), affirmed, 144 F. 2d 276 (C. C. A. 9th). In so far as the *Felix* case appears to rest on the retention of a reversionary interest in the property, it is believed to be contrary to the principle that the provisions for payment, not the form of the conveyance or the local law respecting legal ownership, determine the existence of a depletable interest. *Supra*, pp. 9-10. Where the lessor retains a reversionary interest in the title to all the oil in place which will become operative upon forfeiture or termination of the lease, moreover, it seems fairly plain that a present depletable interest does not exist in the lessor merely because he may become repossessed of his complete capital investment at some future time.

the lease reserved to itself a one-sixth oil royalty, thus reserving to itself an interest in the oil in place.

Also, in *Crawford v. Commissioner, supra*, the Tax Court concluded that the right to share in net profits was a depletable interest because the lessor "retained an economic interest in the oil by virtue of the royalty interest retained in each of the leases."

We submit that it is altogether untenable to hold that an interest in the operator's net profits may or may not represent a depletable interest, depending upon whether the right to receive royalties has been retained. A royalty, representing the right to share in the production of the oil, clearly gives rise to gross income from the sale of oil and is depletable. But how that interest becomes enlarged to include a more extensive one in the production of oil merely because there is an additional right to share in net profits, or how the share of net profits represents a share of the production of oil *only* when there is another and different right to a portion of production through oil royalties, is exceedingly difficult to comprehend.

We submit that there is no reason why a share in the operator's net earnings should give rise to a depletable interest in the oil produced; but if such a reason does exist, the net profits should not be chameleonic, their character changing with the

other interests which the assignor or lessor may possess.*

In this respect, there is so decided a difference between a cash bonus payment and an interest in net profits, that it cannot be argued that the latter, like the former, is depletable when accompanied by a royalty interest, but that it is not

* We believe that the unsoundness of the Tax Court's position in cases of this sort must be evident from a consideration of the incongruity that would result if its rulings were applied to a situation where the taxpayer does not retain a royalty interest at the time of the operating agreement, but acquires one later. For example, if there had been an outstanding royalty interest in the *Japhet* case which was owned by a third party and if the taxpayer in that case had received a cash payment and the right to share in the operator's net profits, the operator undertaking to pay the one-eighth royalty to the owner of the outstanding mineral interest, the Tax Court ought to hold that the taxpayer could not take depletion on the net profits received. Thus, the operator would receive seven-eighths of the depletion allowance and the owner of the royalty interest would be entitled to one-eighth of the deduction. If, later, the taxpayer should acquire the outstanding royalty interest, would the taxpayer then be entitled to take depletion on the net profits received as well as on the royalty interest? The reasoning of the Tax Court in the present case and in the *Crawford* case, *supra*, would apply equally well to that situation. Yet, we submit, it is fairly obvious that the operator's right to depletion should not be diminished by a transaction in which he would have no interest and to which he would not be a party. We believe that the taxpayer in that situation ought not to be entitled to depletion on the net profit payments and we believe, with equal force, that there are no reasons why the taxpayer here should be entitled to the deduction with respect to the net profit payments. Cf. *Badger Oil Co. v. Commissioner*, 118 F. 2d 791 (C. C. A. 5th), certiorari denied, 314 U. S. 634.

depletable when no royalties have been retained. Where the owner of oil producing property transfers all his interest in the underlying oil for a cash consideration and "severs his connection with the production of oil and gas and the income derived from production," the money received constitutes the proceeds derived from the sale of a capital asset. *Anderson v. Helvering*, 310 U. S. 404, 408. If he also retains an oil payment, he is regarded as having sold all of his interest in a portion of the oil in place and as having retained an interest in so much as will satisfy the payments due him. He is entitled to depletion only on the oil payments (*Thomas v. Perkins*, 301 U. S. 655); the cash is regarded as proceeds from the interest sold and no part of it is treated as a depletable bonus (*Commissioner v. Fleming*, 82 F. 2d 324 (C. C. A. 5th); *Cullen v. Commissioner*, 118 F. 2d 651 (C. C. A. 5th); *Hammonds v. Commissioner*, 106 F. 2d 420 (C. C. A. 10th); *Commissioner v. Roeser & Pendleton*, 118 F. 2d 462 (C. C. A. 5th), certiorari denied, 314 U. S. 635; *Columbia Oil & Gas Co. v. Commissioner*, 118 F. 2d 459 (C. C. A. 5th)).

Where, however, the owner retains a fractional interest in production through an oil royalty and invests his transferee with a partial interest in the oil to be produced, a cash bonus received by the owner does not represent the proceeds from the sale of a capital asset. *Burnet v. Harmel*, 287 U. S. 103; *Cullen v. Commissioner*, *supra*. The reasoning underlying this result is important.

Because of his royalty interest, the lessor has continuing rights in the extraction and sale of all of the underlying oil; his interest extends to a fractional portion of every barrel of the oil in place; under such circumstances, the bonus can no more be regarded as the proceeds from the sale of a capital asset than the royalties themselves, which are considered as ordinary income. *Burnet v. Harmel, supra*. In this manner, the bonus is regarded as "payment in advance for oil and gas to be extracted," and, since it represents "gross income from the property," it constitutes a depletable interest. *Herring v. Commissioner*, 293 U. S. 322, 324. Thus, whether the cash payment is a return of capital, or ordinary gross income from the property, depends upon whether the recipient retains a continuing interest in production. Only when the cash payment constitutes gross income from the production and sale of oil does it represent a depletable interest.

This reasoning has no application to an interest in net profits. Even where a royalty interest is retained, a share in net profits payable over the term of the lease does not constitute a depletable interest because although, like a bonus, it constitutes ordinary income to the recipient, unlike the bonus, it does not constitute "gross income from oil and gas" (*Helvering v. Twin Bell Syndicate*, 293 U. S. at p. 321), and it certainly cannot be considered as "payment in advance for oil and gas to be extracted" (*Herring v. Commissioner*,

293 U. S. at p. 324). The payments are not in anticipation of extraction but are to be made only if the lessee is able to earn profits. Moreover, the treatment of a bonus as an advance royalty has been expressly incorporated in the applicable Treasury Regulations ever since 1918. *Douglas v. Commissioner*, 322 U. S. 275. An interest in net profits payable over the term of the lease has never been considered depletable; the regulations applicable here expressly provide to the contrary.⁶

Petitioner suggests (Br. 15-16) that the Commissioner was pursuing an inconsistent position in refusing to grant the taxpayer the allowance for depletion with respect to the net profit payments received and, at the same time, in taxing the payments to it as ordinary income.⁷ Actually, no inconsistency exists whatsoever.

So far as the lessor is concerned, the net profit payments received have all the attributes of

⁶ See *supra*, p. 19. *Spalding v. United States*, 97 F. 2d 607 (C. C. A. 9th), certiorari denied, 305 U. S. 644, relied on by the taxpayer (Br. 21-22), did not involve a sharing of the operator's profits.

⁷ Judge Hutcheson stated in his dissenting opinion (R. 48):

"The commissioner does not contend that the 20 percent payments are taxable as ordinary income to the lessees and not to the taxpayer, as was successfully contended in some of the cases commissioner cites, and as would be the case here if the commissioner is right. Quite to the contrary, he accepts them as ordinary income as they were returned by Kirby, and insists on taxing them as such. As *Anderson v. Helvering* makes clear, if Kirby is not entitled to depletion on these payments, it is because they are the income of the operators and taxable to them."

ordinary income. Cf. *Schermerhorn Oil Corp. v. Commissioner*, 46 B. T. A. 151. This is true even if, from the standpoint of the lessee, the payments are regarded, not as a deductible business expense, but as a consideration for the lease, for it is not at all incongruous to view the net profit payments as "consideration for the lease and * * * income of the lessor." *Burnet v. Harmel*, 287 U. S. 103, 112. [Italics supplied]. "Not infrequently, payments made for an article constitute a capital investment by the payor, but income to the recipient." *Sunray Oil Co. v. Commissioner*, 147 F. 2d 962, 966 (C. C. A. 10th), certiorari denied, May 21, 1945. Because of its continuing interest in production by way of oil royalties, the lessor has not made a sale of any capital assets. Instead, in addition to its retained interest in production, the lessor has contracted for and has received an economic advantage resulting from the operator's ability to earn profits. That contractual right results in the receipt of taxable income even though it does not constitute gross income from the property. It is no more gross income from the property than would have been the case if the lessees had promised to pay a stipulated portion of the profits from their entire business and not merely from the operation of these particular oil properties. Thus, the receipt of a share of the net profits is analogous to the receipt of "delay rentals" which, although ordinary income to the lessor, are not income from the

proceeds of oil and gas and, hence, are not subject to depletion. *Houston Farms Development Co. v. United States*, 131 F. 2d 577, rehearing denied, 132 F. 2d 861 (C. C. A. 5th); *Commissioner v. Wilson*, 76 F. 2d 766 (C. C. A. 5th).

So far as the lessees are concerned, the income from the oil produced from the property, except for the advance and present royalty interests retained by the lessor, is gross income to them includible in their taxable income in full and with respect to which they are entitled to percentage depletion. The net profit payments are not to be excluded from their gross income in computing depletion under Section 114 (b) (3) as "rents or royalties paid or incurred by the taxpayer in respect of the property." *Burton-Sutton Oil Co. v. Commissioner*, 150 F. 2d 521 (C. C. A. 5th), petition for a writ of certiorari filed, No. 361, this Term; Section 19.23 (m)-1 (f) of Treasury Regulations 103 (Appendix, *infra*, pp. 45-46). See also, *Quintana Petroleum Co. v. Commissioner*, 143 F. 2d 588 (C. C. A. 5th). This exclusion clause, which was first incorporated in Section 114 (b) (3) of the Revenue Act of 1932, c. 209, 47 Stat. 169, was merely declaratory of the proper construction of Section 114 (b) (3) of the Revenue Act of 1928, c. 852, 45 Stat. 791, and corresponding provisions of the Revenue Act of 1926, c. 27, 44 Stat. 9 (Section 214 (a) (9)), which provided merely for the allowance of percentage depletion based on "gross

income from the property" without a specific exclusion clause (see *Helvering v. Twin Bell Syndicate*, 293 U. S. 312; H. Rep. No. 1492, 72d Cong., 1st Sess., p. 14 (1939-1 Cum. Bull. (Part 2) 539, 542)), and the amount to be excluded from the lessee's gross income from the property now, as before the amendment, is an amount which will represent the lessor's gross income from the property.* See *Helvering v. Twin Bell Syndicate*, *supra*; *Thomas v. Perkins*, 301 U. S. 655. The word "rent" in this clause is used synonymously with royalties to denote a share of production. This Court has used the term "rents or royalties" to describe the payments made for the privilege of extracting iron ore (*Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, 522) and in some jurisdictions an oil royalty interest is described as a "rent" and gives rise to the same legal consequences (*Elsinore Oil Co. v. Signal Oil Etc. Co.*, 3 Cal. App. 2d 570; *Miller v. Carr*, 137 Fla. 114; *Mc-*

* While the taxpayer asserts (Br. 16) that the net profit payments were " * * not even included by the respondent in the taxable income of the lessee" and " * * the respondent did not class it [the net profit payments] as taxable income of the lessee," we are informed by the Bureau of Internal Revenue that the lessees reported in their gross taxable income the full amount received from the sale of five-sixths of the oil produced, and that there was no exclusion on account of the net profits payments made. Likewise, the lessees claimed, and were allowed, a deduction for depletion calculated on the gross income from five-sixths of the oil produced and sold, undiminished by the amount of their net profits paid to the taxpayer.

Intire's Administrator v. Bond, 227 Ky. 607; *Crain v. West*, 191 Ky. 1; *Roberson v. Pioneer Gas Co.*, 173 La. 313; *Board of Com'rs of Caddo Levee Dist. v. Pure Oil Co.*, 167 La. 801; *United Gas Public Service Co. v. Barrett*, 179 So. 506 (La. App.); *Gray v. Commissioner*, 5 T. C. No. 33; cf. *Commissioner v. Wilson*, 76 F. 2d 766 (C. C. A. 5th)).

Even if the decisions of this Court were less clear in supporting the Commissioner's determination in this case, we believe that the unsoundness of the taxpayer's position would be evident from the peculiar and labored concepts which it must advance in support of its theory. That is, the taxpayer must assert that, in addition to its fractional royalty interest, an indefinite portion of each barrel of oil produced *may* represent oil in which it had a capital investment prior to severance, depending upon whether the lessees *happen* to earn profits. We believe that there is no warrant for concluding that a greater proportion of the taxpayer's oil lies near the surface and is extracted in the years when there are operational earnings, but that a greater proportion of the lessee's oil is produced and sold in the years when there are no profits. If such reasoning had any validity, it could as easily have been applied to conclude that the taxpayer in the *Elbe* case had retained, and that the taxpayer in the *O'Donnell* case had acquired, an interest in the oil in place which was depleted in the years that there were

net profits, and that the extent of that interest depended on the amount of the net profits earned.

If, during the time that there may be no net profits, all the oil produced, over and above that represented by the lessor's interest in gross production, belongs to and is attributable to the lessee, it seems plain that the same proportion of the oil produced remains the lessee's oil during the time that there are net profits. A lessee cannot, by agreement, divest himself of the attributes of ownership and exclude from his taxable income the proceeds derived from the sale of oil which belongs to him. Cf. *Harrison v. Schaffner*, 312 U. S. 579; *Helvering v. Eubank*, 311 U. S. 122; *Helvering v. Horst*, 311 U. S. 112; *Helvering v. Clifford*, 309 U. S. 331; *Burnet v. Leavinger*, 285 U. S. 136; *Lucas v. Earl*, 281 U. S. 111.

The theory which the taxpayer must advance, and which is partially expressed in the dissenting opinion in the Circuit Court of Appeals, becomes transparently untenable when pursued to its logical conclusions. Thus the taxpayer contends (Br. 22) that "The provision concerning net profits was merely a method of determining the part of the minerals or their proceeds that should be paid to the petitioner as the owner of the minerals in fee." Also, the dissenting opinion below considered the provision for dividing the net profits as only a shorthand way of stating that the "lessor retained, and was to have, 20 percent of the gross profits from production, subject,

however, to the payment of 20 percent of the specified expenses, * * * (R: 46).^{*} These statements are of attractive simplicity but lose all substance when critically examined for meaning.

If the parties truly intended that the taxpayer should have an additional right to gross production, then the "gross income" from the property which is attributable to the taxpayer, and with respect to which it is entitled to depletion, has been obviously distorted. The anomalies which ensue can best be illustrated by a simple example. Assume that there is a leasing agreement whereby the lessor reserves a one-eighth royalty interest and is entitled to 20 percent of the lessee's net profits, that the gross price of crude oil is \$1.15 per barrel, and that the cost of production is 70 cents per barrel, with a net of 45 cents per barrel. If 300,000 barrels are produced, the total gross income from the property would be \$345,000, of which the lessor would be entitled to \$43,125 (or 37,500 barrels) on account of his royalty interest. The total net profits of the lessee, after deducting the royalties paid (as the agreement in this case provides), would be \$91,875, of which \$18,375

^{*} We do not understand that Judge Hutcheson suggests that the taxpayer was entitled (over and above its royalty interest) to 20 percent of gross production and was to be personally liable for 20 percent of the specified expenses. Under the agreement (R: 29-34), it is quite clear that the taxpayer would not be liable for any portion of the expenses during such time as there might be an operating deficit, and had no personal liability for any expenses at any time.

would be payable to the lessor. If the lessor's share actually represented, as the dissenting opinion suggests, 20 percent of gross production (remaining after the one-eighth royalty),¹⁰ subject to the payment of specified expenses, then the lessor actually received 52,500 additional barrels of oil ($\frac{1}{8} \times (300,000 \text{ minus } 37,500)$) and the total production of its oil was 90,000 barrels (37,500 plus 52,500).

If 90,000 barrels of oil are attributable to the lessor, the remainder, or only 210,000 barrels, are attributable to the lessee. His gross income therefrom, on which depletion may be claimed and which must be reported as gross taxable income, is \$241,500 ($210,000 \times \1.15). On the taxpayer's theory, the lessor's total gross income from the property is \$61,500 (\$43,125 on account of the one-eighth royalty plus \$18,375 on account of its share of net profits). The total gross income on which both the lessor and lessee would take depletion and which, separately, would be reported as gross taxable income, is \$303,000 (\$241,500 plus \$61,500). This may be compared with the *actual* total gross income from the property of \$345,000. Thus, \$42,000 disappears altogether from the total gross income from the

¹⁰ It is assumed that Judge Hutcheson intended to say that the taxpayer was entitled to 20 percent of the production remaining after it received its royalty oil. If he meant that the taxpayer had reserved 20 percent of all production without deducting its royalty interest, the example given above becomes more extreme.

property which must be reported for tax purposes and on which someone ought to receive percentage depletion.

This aberration plainly stems from the fallacious assumption that the lessor retained 20 percent of gross production subject to the payment of 20 percent of the expenses. And an attempt to avoid this disparity must lead to a true dilemma. One horn of the dilemma would lead to the conclusion that the lessor's interest is in the production of so many barrels of oil which, less expense of production, equals its share of the net profits payable. In the example given, the production of 40,833 barrels¹¹ is necessary to earn \$18,375. The gross income from 40,833 barrels would be \$46,958, and the lessor, if the theory is correct, ought to be entitled (in addition to its royalty interest) to depletion on this amount, and not on only \$18,375, the amount of net profits received. Also, \$46,958 is the amount which the lessor would be required to include in its gross taxable income, from which it would only be entitled to claim appropriate deductions in computing its taxable net income. If the lessor's interest in net profits truly represents an interest in gross production less expenses, the net profits received cannot represent gross profits.^a The lessor could not automatically claim a deduction for all items which, under the

¹¹ This, of course, does not equal one-fifth of the lessee's gross production, less royalties paid, which is actually 52,500 barrels.

contract, entered into the computation of "net profits", since all of these might not be deductible for tax purposes; the lessor certainly could not short circuit matters by failing to claim appropriate deductions and by reporting what it considered its net income as though it were gross income.¹²

The taxpayer, apparently, recognized the absurdity of this and did not claim depletion on the full gross proceeds calculated in this manner, nor did it report the full gross income which would be attributable to it under this theory. It must have also realized that if this theory were applied in this manner, the percentage of the oil which would be attributable to it would have no relation to the percentage of net profits payable. See *supra*, note 11.

The theory actually adopted by the taxpayer and the dissenting judge, however, follows the other horn of the dilemma. Basic to this theory is the assumption that, although the taxpayer was entitled to an additional 52,500 barrels of oil over its royalty interest, its gross income therefrom was only the portion of the net profits which it received, it being assumed that *Helvering v. Mountain Producers Corp.*, 303 U. S. 376, was applicable. Pet. Br. 12-15, 24-25. That case, however, is distinguishable in all respects and

¹² Some of the expenses deducted in computing net profits under the agreement (R. 31-32) might constitute nondeductible capital expenditures.

can have no possible application here. The *actual* price at which the oil was sold, it was held in the *Mountain Producers* case, constituted the gross income from the property on which depletion was to be taken; the fact that the selling price was not based on market price and that the purchaser undertook to pay the cost of production did not alter or add to the gross amount for which the oil was sold. In the present case, however, it is altogether clear that, if 52,500 barrels constitute oil in which the lessor has an interest, the gross selling price is the actual proceeds, if sold to third parties, or the current price, if purchased by the lessees, undiminished by any costs.¹³ This, too, is the gross income, as defined by Section 19.23 (m)-1 (f) of Treasury Regulations 103 (Appendix, *infra*,

¹³ In this respect, the agreement provides (R. 32-33):

"First Party shall have exclusive charge and control of the marketing of all oil, gas and other minerals produced from said premises, and in which the parties hereto may be interested. Upon the sale of any of such minerals, the accounts covering the lease referred to above, shall be credited with the proceeds of such sales. If it desires to do so, First Party may take over all or any part of such production itself for its own use and benefit, and in such event, the accounts (covering the lease referred to above) shall be credited on the following basis, to-wit:

"(a) On Oil: The current price per barrel on the date of respective runs to pipe line, or if not run to pipe line, then on date of respective runs to storage for account of First Party, posted by First Party for the field where the production is located,

"(b) For gas of any kind: The market value at the well.

"(c) Other Minerals: The market value at the well or mine."

pp. 45-46) which provides that "gross income from the property" shall be "the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well." Accordingly, *Helvering v. Mountain Producers Corp.*, *supra*, has no application to the facts of this case, and the actual result which the view of the taxpayer and the minority below would achieve cannot possibly be in harmony with the theory advanced in support of it. That the *Mountain Producers* case has been misconceived is evident from the assertion (Pet. Br. 15) that the taxpayer in that case received "net profits". Actually, however, the taxpayer in the *Mountain Producers* case was entitled to a specified sum for each and every barrel produced; no production could take place in which the taxpayer in that case did not have a monetary interest, and that would be true even when there might be no profits from operations, i. e., if production expenses exceeded the selling price. Thus the taxpayer in that case, unlike a party who receives a portion of net profits, had a partial but continuing interest in the production of oil which represented a depletable interest, and the only issue was how that interest should be measured.

Returning to results rather than theory, it is submitted that to grant the depletion allowance with respect to an interest in net profits is to ignore the physical realities of the situation. The Commissioner's position, on the other hand, is in

accord with actual economic factors. One cannot overlook the fact that physical depletion of the oil deposits takes place to the exact extent that there is gross production. Permitting the depletion allowance to be shared by the parties in the same proportion as they are entitled to participate in gross production, which the Commissioner contends is the only proper manner, obviously conforms to the manner in which physical depletion occurs as the oil is extracted. There is, however, no constant relation between production which results in depletion and the earning of profits. Severance of the oil may continue without the operator being able to show any earnings, or there may be relatively heavy production with only a small amount of profits. The granting of the depletion deduction to a lessor in accordance with his right to share in the lessee's net profits would change the fundamental nature of the allowance and would make it depend upon matters that have no bearing on the amount of physical depletion that occurs.

Applying the principles enunciated by this Court to the case at bar, it is clear that prior to the execution of the lease and the agreement, the taxpayer, as the fee owner, had the entire capital investment and depletable interest in the underlying oil and gas, with the exception of the one-eighth mineral interest outstanding in one tract of land. After the execution of the lease and

agreement, the taxpayer retained a direct interest in the oil produced to the extent that an oil royalty, or a share of gross production, was reserved to it. Consequently, the taxpayer retained its capital investment in a proportionate amount of the oil in place. As production occurred, the taxpayer received a partial return of capital and, in recognition of that, the statute permitted a deduction for percentage depletion on the gross income from that production. Likewise, to the extent that the taxpayer received advance royalties in the form of a cash bonus, advance depletion was allowed and an interest was retained in a proportionate amount of the oil and gas deposits which suffered physical depletion as the minerals were extracted. The owner of the outstanding mineral interest in one tract, of course, had a depletable interest in a corresponding amount of the oil and gas in place there. The lessees, however, acquired a direct interest in all the remaining production of the oil and gas. Aside from the aliquot share of gross production which was attributable to the taxpayer's retained interest (represented by the advance and present royalties) and to the owner of the outstanding mineral interest, the remainder of the oil produced was attributable to the lessees' interest and, as production took place, that interest became proportionately depleted. The lessees were entitled, therefore, to percentage depletion on the gross proceeds derived from the production

and sale of all the remaining oil. Their right to the deduction could not be partially defeated by the taxpayer's claim to depletion on the share of the lessees' net profits to which it was entitled.

The single deduction for depletion being allotted to the parties in that proportion, it plainly follows that the lessor was not entitled to any additional deduction with respect to the share of the lessees' net profits which was payable to it. Since the lessees' net profits bear no direct relationship to the amount of oil produced, and since production and physical depletion of the deposits may occur without there being any net profits, the lessor, having no assurance of a share upon production in this respect, does not have an interest in the oil in place for which the depletion allowance is granted.

II

THE DECISION OF THE TAX COURT WAS "NOT IN ACCORDANCE WITH LAW" AND WAS PROPERLY REVERSED BY THE CIRCUIT COURT OF APPEALS

The Tax Court adopted as its findings of fact (R. 11) a stipulation which had been agreed on by the parties (R. 22-36). The Circuit Court of Appeals reached its decision on the basis of those facts. While, as the taxpayer correctly states (Br. 10), the Tax Court considered the lease (R. 24-28) and the contemporaneous agreement granting participation in the operators' earnings (R. 29-34), as though they were one transaction

for tax purposes, there is no warrant for the complaint made in the petition for a writ of certiorari that the court below disregarded this and treated the transactions as separate (Pet. 4, 5, 14-15). The Circuit Court of Appeals did not even intimate that its decision was based upon the fact that two separate documents were signed or that it would have reached a different result if the agreement had been embodied in the lease. Both the Tax Court and the Circuit Court of Appeals arrived at their respective conclusions without attaching the least bit of significance to this fact, and the taxpayer, apparently, has now abandoned its contention to the contrary (Br. 4).

The Circuit Court of Appeals did not differ with the Tax Court on what the facts were, or on what proper factual inferences should be drawn; it did differ with the Tax Court respecting the proper interpretation of the phrase "gross income from the property" in Section 114 (b) (3) of the Internal Revenue Code (Appendix, *infra*, p. 44). Cf. Pet. Br. 7-12. As we have shown, that phrase has acquired a very definite meaning through a long-continued construction by this Court and repeated Congressional enactment. If, as we contend, the decision of the Tax Court rests on a departure from that meaning, the decision is "not in accordance with law" and was properly reversed on review. Section 1141 (c) (1) of the Internal Revenue Code; *Trust u/w of Bingham v.*

Commissioner, decided by this Court on June 4, 1945; *Security Mills Co. v. Commissioner*, 321 U. S. 281; *Dixie Pine Co. v. Commissioner*, 320 U. S. 516; *Helvering v. Amer. Dental Co.*, 318 U. S. 322. Also, in holding that an interest in net profits constitutes "gross income from the property" if it is accompanied by a royalty interest in gross production (see *supra*, pp. 20-21) the Tax Court is applying a rule of general applicability which is properly subject to correction by the reviewing court. *Trust u/w of Bingham v. Commissioner, supra*.

It must be apparent that the present case gives rise to an entirely different kind of question than that presented by cases where the crucial issue must be determined by examining imperceptible variations in factual matters that may be present in particular instances. In transactions looking to the exploitation and development of oil and gas deposits, each type of payment gives rise to the same economic consequences regardless of other variations which may be found in the agreements between the parties. As a result, the application of general rules to crystalized factual patterns in such cases does not necessitate that the same finality be accorded the determinations made by the Tax Court as is true in situations where it is necessary to evaluate subtle changes from case to case in arriving at a correct or permissible determination.

CONCLUSION

In view of the foregoing, the judgment of the
Circuit Court of Appeals should be affirmed.

Respectfully submitted.

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OCTOBER 1945.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion*.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income bene-

ficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

(26 U. S. C. 23.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(b) *Basis for Depletion.*—

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be $27\frac{1}{2}$ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

(26 U. S. C. 114.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.23 (m)-1 [as amended by T. D. 5413, 1944 Cum. Bull. 124, 129]. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of im-*

provements.—Section 23 (m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

(f) * * *

In the case of oil and gas wells, "gross income from the property" as used in section 114 (b) (3) means the amount for

which the taxpayer sells the oil and gas in the immediate vicinity of the well. * * *

* * *

In all cases there shall be excluded in determining the "gross income from the property" an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the "gross income from the property." If royalties in the form of bonus payments have been paid in respect of the property in the taxable year or any prior years or if advanced royalties have been paid in respect of the property in any taxable year ending prior to December 31, 1939, the amount excluded from "gross income from the property" for the current taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the product sold during the taxable year. If advanced royalties have been paid in respect of the property in any taxable year ending on or after December 31, 1939, the amount excluded from "gross income from the property" for the current taxable year on account of such payments shall be an amount equal to the deduction for such taxable year taken on account of such payments pursuant to section 19.23 (m)-10 (e).

* * *

SEC. 19.23 (m)-4. *Computation of depletion based on a percentage of income in the case of oil and gas wells.*—Under section 114 (b) (3), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ percent of the gross

income from the property during the taxable year, but such deduction shall not exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of "gross income from the property" and "net income of the taxpayer (computed without allowance for depletion) from the property," see paragraphs (f) and (g) of section 19.23 (m)-1.) In no case shall the deduction computed under this section be less than it would be if computed upon the cost or other basis of the property provided in section 113.